In the Supreme Court of the United States

OCTOBER TERM, 1978

Nos. 78-606, 78-607

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner.

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.,
Respondents.

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner.

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.,
Respondents.

BRIEF IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI

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Respondents, the City and County of San Francisco, the City of Los Angeles, and the City of San Diego (Cities), were parties in the California Supreme Court proceedings, subject of the Petitions in No. 78-606 and No. 78-607. The Cities respectfully present this "Brief in Opposition to Petitions for Writ of Certiorari".

PRELIMINARY STATEMENT

San Francisco and San Diego receive telephone service from the Pacific Telephone and Telegraph Company (Pacific), and Los Angeles' service is from both Pacific

and the General Telephone Company of California (General).

The California Supreme Court orders of July 13, 1978, subject of the instant petitions, are the culmination of years of litigation. Prior to those orders, the issue of a reasonable allowance for prudently incurred income tax expense for the purpose of computing intrastate rates was the subject of eleven California Public Utility Commission (PUC) cases or applications,[1] three unanimous written California Supreme Court decisions,[2] and one application to the United States Supreme Court for stay.[3] One or all of the Cities were parties to each of these proceedings. The Cities prevailed in all of the court proceedings.

OPINIONS BELOW

The decisions of the PUC and the California Supreme Court, cited in the "Opinions Below" sections of the petitions of Pacific and General, follow multiple remands of this issue from the California Supreme Court. The opinions below can only be analyzed in conjunction with the full unanimous written opinions of the California Supreme Court in *City of San Francisco* v, *Public Utilities Commission* 6 C.3d 119 (1971) and *City of Los Angeles* v. *Public Utilities Commission* 15 C.3d 680 (1975) (*San Francisco* and *Los Angeles II*). These decisions appear at Appendix A of Respondents' Joint Appendix (cited as R.App.) pp 1RA-51RA.

1. PUC cases listed in Petitioners' Appendix B (cited as P.App.) pp 3A-5A.

2. *City and County of San Francisco* v. *Public Utilities Commission*, 6 Cal. 3d 119 (1971); *City of Los Angeles* v. *Public Utilities Commission*, 7 Cal.3d 331 (1972); *City of Los Angeles* v. *Public Utilities Commission*, 15 Cal.3d 680 (1975) (hereafter cited as *San Francisco, Los Angeles I* and *Los Angeles II*).

3. Application of Pacific to stay refund order in *Los Angeles I*, No. A69, October Term 1971, *Pacific Telephone* v. *City of Los Angeles*. Filed July 13, 1972. Denied by Justice White and Justice Rehnquist July 28, 1972.

QUESTIONS PRESENTED

Pacific contends at pp. 2-3 that the rate making method adopted by the California Supreme Court is in violation of the Supremacy Clause of the United States Constitution and deprives it of Fourteenth Amendment rights. General at page 2 of its petition adopts Pacific's Fourteenth Amendment argument, but did not adopt the Supremacy Clause argument, and asks the Court to issue an opinion on the question of whether the rate making methods adopted by the California Supreme Court will deprive Pacific and General of their eligibility under the Internal Revenue Code to continue the use of accelerated depreciation and the investment tax credit (JDIC).

The Cities contend that the relevant questions arising from the California decisions are simply (1) whether the rate making methods adopted by the PUC are consistent with the criteria set forth in California law as interpreted by the California Supreme Court, irrespective of federal income tax eligibility consequences, and (2) whether an intrastate rate making body may take into account managerial imprudence in setting intrastate rates. It is submitted that there are no substantial Federal questions raised in these issues and that the Petitions for Writ of Certiorari should be denied.

STATEMENT

The statements of the "Proceedings Below" by General (pp 9-10) and Pacific (pp 8-12) are at best incomplete. The history of these proceedings is lengthy and complex[4]. It will be briefly summarized in this section with respect to Pacific and the accelerated deprec-

4. The California Supreme Court in a section captioned "*1. The background of the present litigation*" in Los Angeles II at R.App. A, pp 21RA-32RA, presents a comprehensive history through 1975.

iation issue. The facts and law relevant to General and the investment tax credit (JDIC) issue are similar and will not be discussed in detail either in this section or throughout the brief.

The cases involve criteria to be applied by the PUC in setting telephone rates by determining what expenses Pacific and General may pass on to their consumers. Both Petitions arise from a series of rulings of the California Supreme Court (see fn. 2) which basically hold that a public utility owes a duty to its consumers to minimize its expenses, including tax expenses. The California Supreme Court has decided, as a matter of state law, that it is managerial imprudence for a public utility willfully to subject itself to a greater tax liability than it is legally required to pay. Customers need not compensate utilities for imprudent expenses.

Thus the California Supreme Court has ruled in 1971 that the PUC may set rates as if prudent options had been exercised. It is the PUC's 1977 rate setting action pursuant to California Supreme Court decisions that is before this Court.

The use of accelerated depreciation for tax purposes provides a utility a substantial tax saving. The amount of savings grows at a substantial rate so that the tax saving resulting from accelerated depreciation in one year is not representative of the far higher savings in future years. From the inception of the tax law in 1954 permitting accelerated depreciation there has been a debate over the proper method of taking into account accelerated depreciation for ratemaking purposes. This debate was summarized by the California Court in *Los Angeles I*:

> "The problem presented is whether the tax saving or tax deferral should inure to the benefit of the ratepayer in the form of lower rates or whether the tax saving or deferral should be retained by the utility with no reduction in rates. When the saving is passed on to ratepayer, the accounting procedure is called accelerated depreciation with flow through. When the saving is retained by the utility, the accounting procedure is called accelerated depreciation with normalization."[5] (footnotes omitted) 7 Cal.3d at 338, 339.

For ratemaking purposes in the 1960's the PUC adopted the flowthrough method and all major utilities in California with the exception of Pacific and General accepted accelerated depreciation for tax purposes and passed on the considerable savings to the ratepayers via the flow through method. (*San Francisco* at R.App. A, p 6RA) Pacific and General refused to take advantage of the tax savings. They chose to pay higher taxes on the straight line basis. (id at 7RA)

Faced with this situation the PUC concluded in 1968 that the rates Pacific could charge its customers should be calculated on the premise that Pacific could have and should have chosen accelerated depreciation and that the benefit of this method, regardless if it was chosen, should be passed on to the consumers through the ratemaking mechanism. The California Supreme Court in 1971 summarized this situation in this manner:

> "On November 6, 1968, in Decision No. 74917 the commission determined that Pacific's management was imprudent in not electing to take accelerated depreciation for income tax purposes. The commission concluded that it could not compel Pacific to take the accelerated depreciation on its federal income tax return, but it held that for purposes of rate making Pacific would be treated as if it had

5. Normalization and flowthrough are *rate setting* terms. Both relate to identical tax methods of calculating depreciation.

> obtained the tax saving of accelerated depreciation and the saving would be flowed through to the consumers in the form of lower rates. (Imputed accelerated depreciation with flow through.) Notwithstanding this, Pacific continued to determine its federal tax liability using straight line depreciation." (San Francisco, supra, at R.App. A, p 7RA)

Pacific did not challenge the 1968 PUC order before the California Court. Instead it successfully lobbied for a change in tax legislation[6] I.R.C. 167(l)—P.App. C, pp 79A-81A) was the result. After this legislation passed, Pacific in 1970 adopted accelerated depreciation for tax purposes.

Under Pacific's interpretation of this law, companies that were on flow through could remain on flow through, but a company such as Pacific which never used accelerated depreciation could only obtain the tax benefits of accelerated depreciation if it was permitted to use the normalization method of accounting.

Pacific next persuaded the PUC, in Decision No. 77984, to permit it to use accelerated depreciation with normalization, on the basis that tax law precluded the Commission from adopting the flow through method.

On November 26, 1971, the California Supreme Court in *San Francisco* annulled PUC Decision No. 77984. In taking this action the Court repeatedly stressed that Pacific's management was "imprudent" in failing to elect to use accelerated depreciation and was "obstinate" in its continuing imprudent policy, (id.

6. The legislation originally supported by the Bell System in 1969 was H.R. 6659 (R.App. C, pp 71RA-72RA). This bill restricted state regulatory authority. Congress did not restrict regulatory agencies' rate making authority as had been proposed in HR 6659, in view of the constitutional problems indicated by Chairman Mills in response to objections of the PUC. "I understand your legal point, that we have no right to tell you how to fix rates on intrastate matters in the State of California. I agree with you, that that would be in invasion of your right." (Hearings on HR 6659, House Committee on Ways and Means, p. 3887, 91st Congress (1969).)

at R.App. A, pp 11-RA-15RA). The Court further found that the so-called normalization method which the PUC had adopted requires ratepayers to put up the capital for the telephone system "contrary to the basic principle of utility rate setting," (id. at R.App. A, p 13RA). In addition, the Court recognized that the effect of normalization "is to reward Pacific for its imprudent management" and is "harsh on the ratepayer" (R.App. A, p 15RA). The Court held that the PUC misapprehended its powers under the state law by not realizing it was empowered to set rates which held the company rather than consumer liable for failure to pursue a depreciation method which reduced tax expense. The Court concluded that the Commission could set rates for Pacific notwithstanding the change in the federal tax statute (R.App. A, p 11RA). The Court specifically pointed out that flow through or a compromise method could lawfully be applied by the PUC and directed the PUC to further consider the proper method for rate making purposes in light of the California Supreme Court's discussion of the options available to the PUC.

Despite the California Supreme Court's specific annullment of the Commission's use of normalization, the Commission continued to set rates on the basis of normalization.

On June 9, 1972, in *Los Angeles I*, the California Supreme Court ordered the Commission to reset rates on a flowthrough basis, both retroactively and prospectively. On July 13, 1972, Pacific filed an application with the United States Supreme Court to stay *Los Angeles I* (*Pacific Telephone* v. *City of Los Angeles*, No. A69). In that application, Pacific told the United States Supreme Court, "The Internal Revenue Service undoubtedly will assert that under the Tax Re-

form Act of 1969 petitioner must compute and pay its federal income taxes for this period, on the basis of straight line depreciation." (No. A69, page 19.) It complained that the refunds were so large as to have serious adverse effect on petitioner's financial condition and its ability to serve the public." (Id at p. 19, fn. 27.) Justice White and Justice Rehnquist each denied Pacific's application on July 28, 1972. Although Pacific's application for a stay was "pending filing of a petition for a writ of certiorari" (Application pages 1-2), no petition was ever filed. The PUC then reset Pacific's rates on flowthrough and ordered refunds of $176,000,000 and rate reductions of $90,000,000 per year.

On September 19, 1972, Pacific reapplied to the PUC to increase its rates. The disposition of that application is before the Court. For income tax purposes, Pacific continued to use accelerated depreciation, which it commenced in 1970. In Decision No. 83162, dated July 23, 1974, the PUC again set Pacific's rates on the identical basis of normalization that had been overturned by the California Supreme Court in *San Francisco* and *Los Angeles I*.

This rate increase was challenged by various parties. In response to a request that the rate increase be stayed, Pacific informed the California Supreme Court that "it was financially capable of any such refund", citing its experience in its refunding in *Los Angeles I*. (p 7, Pacific Memorandum, August 16, 1974.) The Court, in response to Pacific's memorandum, allowed Pacific to collect the full rate increase subject to refund.[7]

The California Supreme Court reviewed the PUC's

7. Pacific's rates have been collected subject to refund since 1974; General's rates have been subject to refund since 1971. The PUC refund orders are stayed pending disposition of this proceeding.

rate treatment of both Pacific and General and again remanded the tax issue to the PUC in *Los Angeles II*, issued in December 1975. The Court stressed in particular that the PUC had not looked at all relevant alternatives and suggested that so-called annual adjustment method could be adopted.

After this remand, the PUC in Decision 87838 (P. App. B) finally adopted a method of ratemaking as directed by the California Supreme Court. It approved a normalization method after safeguards were incorporated into the calculations to preclude Pacific and General from experiencing windfall profits. (Findings 3 and 4, P. App. B pp. 45A-46A.) This method is virtually identical to the annual adjustment method approved in Los Angeles II (R.App. A, pp 33RA-46RA). The PUC recognized that the growth in the normalization reserve for both accelerated depreciation and investment tax credit was abnormal. (Finding 5, P.App. B., p. 46A.) Failure to recognize such growth yields earnings in excess of those based on a normalization basis. Refunds and rate reductions were ordered based on this tax treatment.

PT&T and General sought review of Decision No. 87838. The Cities defended the PUC order on the grounds it was consistent with the remand instructions of the California Supreme Court. The California Supreme Court denied Pacific's and General's petitions for writ of review on July 13, 1978. The instant petitions to this Court followed.

SUMMARY OF ARGUMENTS

I. The Court Should Not Issue An Advisory Opinion On Tax Eligibility.

A. Adequate grounds, independent of the tax eligibility issue, were raised before the California

Supreme Court that could form the basis for its decision.

B. There is presently no tax controversy over the eligibility of General and Pacific and General's request is for an advisory opinion.

C. There is little likelihood that there ever will be a tax controversy.

D. If there ever is a tax controversy, the parties to the controversy would be the taxpayers American Telephone and Telegraph and General Telephone and Electronics (AT&T and GT&E), and the Internal Revenue Service (IRS). None of these parties was a party in the PUC or California Supreme Court proceedings or are they parties in this proceeding.

E. The positions of the parties in any future dispute are unknown as positions for rate purposes could differ from positions for tax purposes.

F. The statutory language in the Internal Revenue Code is so clear that the tax issue raised is not substantial.

II. The PUC Decision Has Only a Narrow Intrastate Impact Not Worthy of Review.

A. The refund and reductions will merely slightly reduce petitioners' windfall profits without adverse impact.

B. PUC decisions have no binding impact on any other state or federal regulator's jurisdiction.

ARGUMENT

The Cities are in accord with the "Brief in Opposition" of the PUC on the issues of "Supremacy Clause" and "Fourteenth Amendment" and will not further address these issues. This brief will discuss General's request for what amounts to an advisory opinion on tax eligibility and indicate that the PUC decision is

limited to intrastate rate making with no national impact. This analysis will demonstrate that there is no basis to grant the petitions.

I. Tax Eligibility Advisory Opinion.

General asks the Court to issue an advisory opinion on the question of eligibility for JDIC and accelerated depreciation under Sections 46(f) and 167(l) of the Internal Revenue Code. The Court should refuse to entertain jurisdiction over this issue.

A. Adequate Grounds Below Independent of Tax Eligibility

The California Supreme Court denied the petitions for writ of review without opinion. (P.App. A, pp 1A, 2A) Before the California Court, Pacific stated that the primary question was, "whether the rate making methods adopted by the California Public Utilities Commission in Decision No. 87838 are consistent with the eligibility requirements of federal law." (Page 1, letter to California Supreme Court, dated June 9, 1978.) PUC and Cities argued the merits of the eligibility issue and also argued that the PUC's order should be sustained *without regard to income tax eligibility.*

The PUC in its letter to the California Court dated June 22, 1978, stated, "Moreover, as the Commission pointed out in its answer, the prime issue is actually that of the lawfulness of the Commission's decision as an exercise of its mandated authority under the California Constitution and the Public Utilities Code." (R.App. B, p 62RA) The Cities' arguments on this point appeared in its Answer and in Cities' letters to the Court of June 26, 1978, and July 5, 1978. (R.App. B, pp 53RA-60RA, 65RA-69RA)

The Cities contended that the PUC adopted a rate making method consistent with the intrastate rate

making criteria promulgated in the California Constitution and Public Utility Code and explained in *San Francisco* and *Los Angeles II*.

The California Supreme Court, in *San Francisco*, unanimously held that the PUC could choose a rate making method "notwithstanding the change in the federal tax statute," and "even assuming the absence of the option" to use accelerated depreciation. (R.App. A, pp 11RA, 14RA) The Court reached this conclusion based on its conclusion of law regarding the PUC's power to enact intrastate rate making adjustments based on its findings of fact that management had imprudently incurred excessive tax expenses.[8] The Court stated,

> Under its general power to prevent a utility from passing on to its ratepayers unreasonable costs, the commission in the instant proceeding, notwithstanding the change in the federal tax statute, could properly find that the federal income tax calculated on the basis of straight line depreciation involved an unreasonable expense and that the unreasonable expense due to such calculation was due to an imprudent management decision.
>
> Although prior to its statutory change, Pacific was free to change its method of accounting on its income tax returns but now may no longer do so, its inability to switch is due to its original imprudent determination to pay federal income taxes on a straight line depreciation basis and its obstinancy after the 1968 Commission decision in adhering to the imprudent determination. (R.App. A, pp 11 RA-12RA).

The California Supreme Court concluded that because flowthrough was a valid intrastate rate making

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8. This Court has recognized that findings of incursion of "wasteful or negligent losses" or "inefficiency or improvidence" justify rate adjustments. *West Ohio Gas Co. v. Public Utilities Com.* 294 U.S. 63, 68, 72 (1935).

practice the PUC could adopt alternative approaches less harsh than flowthrough. (*San Francisco* at R.App. A, pp 15RA-16RA). In *Los Angeles II* the Court held that the annual adjustment method, similar to that adopted in the instant case, was a permissible rate setting alternative. (R.App. A, pp 33RA-46RA). The rate making method finally adopted by the PUC is consistent with the holding of the California Supreme Court in *Los Angeles II*, remanding the issue to the PUC with instructions.

These independent grounds raised before the California Supreme Court were adequate to support the California Court's decision irrespective of the tax eligibility issue. Under these circumstances, the Court should presume that the California Supreme Court decision was based upon these independent grounds raised below.

B. No Present Controversy

There is no present tax controversy. Petitioners' parents, AT&T and GT&E, use accelerated depreciation. IRS audits have not challenged past use of these tax options or restricted future use.

C. Uncertainty of Future Controversy

Pacific has raised the spectre of ineligibility at various times in the past and has been *proven* clearly wrong. In *Pacific Telephone* v. *City of Los Angeles*, an Application for a stay of the California Supreme Court's refund order in *Los Angeles I*, filed in the United States Supreme Court, No. A69, dated July 13, 1972, Pacific claimed, at page 19,

> "Under the Court's order the Commission is required to reinstate the 1968 rates. These rates are on the basis of accelerated depreciation with flowthrough. In this situation the Internal Revenue Service undoubtedly will assert that under the Tax

> Reform Act of 1969 petitioner must compute and pay its federal income taxes for this period on the basis of straight line depreciation. Thus petitioner can be required to pay millions of dollars in taxes, no part of which it will be able to recover in rates."

Justice White and Justice Rehnquist each denied Pacific's application on July 28, 1972.

Pacific's rates were then reset by the PUC on the basis of flowthrough. *IRS audits* confirmed Pacific's eligibility for accelerated depreciation and JDIC despite the use by the PUC of flowthrough for rate purposes. In the period 1970-1973 Pacific kept its books on the basis of normalization and had its rates set on the basis of full flowthrough. Despite its predictions of ineligibility to this Court, Pacific continued to use accelerated depreciation and JDIC. The IRS has audited Pacific's books for 1970-1973 and has not made any assessment because of Pacific's JDIC or accelerated depreciation practices.

In arguments before the California Supreme Court in the 1978 case (SF No. 23746), Pacific alleged that it faced retroactive ineligibility dating back to 1970.[9] This claim has proven to be erroneous with respect to the years 1970-1973. The 1970 IRS audit was complete *prior* to the filing of Pacific's California petition. While the issue was before the California Supreme Court the IRS completed its 1971-1973 audit without questioning eligibility. Although Pacific on June 9, 1978, informed the Court of a letter from a Geoffrey Taylor of the IRS related to accelerated depreciation (P.App. D), Pacific never informed the California Court of the results of the IRS audit.[10]

9. Pacific's claimed federal income tax liability was presented by Pacific on pages 71 through 73 of its Appendix to its petition to the California Supreme Court in S.F. No. 23746. It appears in R.App. D, pp 75-77.

10. Pacific only claims retroactive problems from 1974 in 78-606 (Pacific Pet. p 21 fn. 31, 22).

Claims of ineligibility made to the United States Supreme Court and the California Supreme Court have been erroneous. The IRS had not challenged Pacific's taxes. It cannot be assumed that the IRS will ever challenge Pacific's eligibility.

D. Absence of Parties

If the eligibility to use accelerated depreciation is ever challenged, the parties to that controversy will be the IRS and the taxpayers, American Telephone and Telegraph (AT&T), General Telephone and Electronics (GT&E), the parents of the petitioners. The parent corporations file consolidated income tax returns. They, not the subsidiaries, are the taxpayers. The parents and the IRS are not parties in the instant proceeding.

E. Uncertain Position of Parties in Event of Tax Controversy.

In the unlikely event that there is a tax controversy over eligibility, the positions of the parties will be developed. Positions in an actual controversy could differ from positions in instant case.

Utilities' Position

For *rate* purposes and purposes of this litigation petitioners claim they will be ineligible to use accelerated depreciation and JDIC. This is a tactical decision. For *tax* purposes, their positions could be considerably different. In 1972, Pacific told this Court it would be ineligible to use accelerated depreciation. It then filed its income taxes on the grounds that it was eligible.

In candid comments to the press a Pacific executive claimed,

> "We will probably fight in tax court against paying those taxes. And to do so we will have to take the exact opposite side of the argument. We will have to maintain that we have been wrong and the Commission right during all these years of disagreement and litigation." (A. C. Latno, Executive

Vice-President, Pacific, quoted on page 1 of the San Francisco Recorder, September 25, 1978.)

Pacific's Treasurer, in testimony to the PUC agreed that there was a possibility that Pacific would in fact challenge any tax assessment on the basis of the arguments the PUC had raised (PT&T A. 58223, R.T. 1539-1540).

Pacific's and General's arguments are simply arguments of convenience for rate purposes. Under these circumstances, it would be beyond the Court's jurisdiction to issue any advisory interpretation of the Internal Revenue Code.

Position of the IRS.

Pacific and General both cite the issuance of Taylor and Holt letters (P.App. D and E) which purportedly uphold their view of ineligibility. General states at page 17 with regard to the IRS letters, "There is no sound basis for questioning its judgment."

These letters should be viewed in perspective. The letters from IRS employees Taylor and Holt (P.App. D and E) responded to specific requests from Pacific and General. Essentially, the petitioners requested that the IRS find them *ineligible* for the use of accelerated depreciation. Pacific's September 29, 1977, letter to the IRS stated at page 6,

> "*Statement of Position.* Although Pacific obviously desires to retain its eligibility for accelerated depreciation, ADR, the class life system and the investment credit, it believes that the Decision clearly conflicts with the eligibility requirements for these tax benefits, and it cannot in good faith seek rulings that the Decision is consistent with those requirements."

General also failed to make a single argument on behalf of eligibility. Under these circumstances, it was

inevitable for Taylor and Holt to send letters such as appear in P.App. D and E.

After issuance of the Taylor letter on June 8, 1978, the IRS still could have made further assessments in its audit of AT&T for the years 1971 through 1973. In the alternative, it could have asked AT&T to extend the period of limitations on assessments beyond June 30, 1978. The IRS did neither. The IRS should be judged on its *actions* in enforcing the tax law and not on a letter of Geoffrey Taylor. This point is reinforced by analyzing another Taylor letter.

On January 11, 1977, Mr. Taylor wrote the New Mexico Public Service Commission that eligibility for JDIC would be lost unless "in determining the overall cost of capital of a utility for rate making purposes, deferred investment tax credits are properly to be included and assigned a rate not less than that considered applicable to common equity." (R.App. D, p 80RA) Mr. Taylor claimed his opinion was "a well-established interpretation of tax law." (p 79RA)

Mr. Taylor's interpretation of the JDIC eligibility provisions, which were in effect since 1971, was novel. For rate purposes, Pacific's capital structure has never been based on this method. Pacific admits that the methods it has employed and advocated in the past have been inconsistent with the Taylor methodology. (CPUC, A58223, Joses R.T. 1212, 1217) To our knowledge, no utility's rates were set on this method prior to 1977.

Despite the fact that Pacific's and all Bell systems' rates were not set in conformity with the method described by Mr. Taylor, the IRS did not challenge the treatment of JDIC by any AT&T affiliate in the 1971-1973 audit, an audit completed over one year after the Taylor letter.

The Taylor letter itself is clearly wrong in inter-

pretation and not enforced by the IRS. The Federal Energy Regulatory Commission, in Carolina Power and Light, Docket No. ER76-495 (Phase II), Opinion 19, August 2, 1978, printed in 15 Federal Power Service 5-619, reviewed Mr. Taylor's letter. It concluded at 5-624:

> "First, on the matter of the IRS information letter, it is our opinion that the statements made therein do not represent a correct interpretation of the requirement of Section 46f."

Any speculation on the IRS position should be based upon what the IRS does, and not upon what Mr. Taylor says. The IRS has wisely failed to follow Mr. Taylor's interpretation of the tax law in its audits of Pacific.

F. Unequivocal Statutory Language.

The answers to the eligibility question raised by General are clear from the statutory language.

Accelerated depreciation

General argues that eligibility for accelerated depreciation will be lost because of an "excessive exclusion from rate base." (Pet. 78-607, p. 12) Pacific cites three prerequisites to the use of normalization for tax purposes. The third one is, "The regulatory agency may not exclude from rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of the cost of service." (Pet. 78-606, p. 6) There is no basis in the Code, implicit or explicit, for these claims. Pacific and General never cite statutory language in support of their claimed ineligibility.

A company that failed to use accelerated depreciation prior to July of 1969 may use accelerated depreciation if it "uses a normalization method of accounting." IRS (Sec. 167(l)(2)(B). (P.App. C, p 80A) This section is applicable to General and Pacific since they

failed to elect accelerated depreciation in the earlier period.

Normalization is defined by statute in Internal Revenue Code Section 167(l)(3)(G) (P.App. C, pp 84A-85A). The statutory definition neither explicitly or implicitly restricts the rate base treatment of the normalization reserve as a condition of eligibility. Congress left no doubt that it was not restricting, in any way, the *rate base* treatment of the deferred taxes reserve.

> "Where normalization is used, this bill in no way diminishes whatever power the agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility's permitted rate of return is calculated." (House Report 91-413, 91st Congress, First Session 1969 at page 133.)

> "The bill does not change the power of the regulatory agency in the case of normalization to exclude the normalized tax reduction on the base upon which the agency computes the company's maximum permitted profits." (Senate Report 91-52, 91st Congress, First Session 1969 at page 173.)

The method of rate base treatment is not relevant to a determination of normalization.

The PUC, in Decision No. 87838 adopted the normalization method of accounting. It *then* made a deduction from rate base of the normalization reserve in conformity with California law.

In California, rates are set as nearly as possible to be representative of future conditions. *Los Angeles I*, 7 Cal.3d at 346. A calendar test year treatment of the normalization reserve would enable Pacific to earn excessive profits above those anticipated for a normalization company. This was explained by the California Supreme Court in *Los Angeles II*. (R.App. A, p 31RA);

"The Commission's staff experts testified that the rapidly accumulating tax reserves presented an anomalous factor in the telephone companies' financial profile similar to that posed by the fuel costs of the power companies.

The Commission accepted this analysis, explaining that: "One consequence of the use of accelerated depreciation by Pacific is to create a rapidly growing reserve for deferred taxes that is totally out of consonance with the roughly harmonious relationship between revenues, expenses, and rate base."

These facts led the Commission to use a four-year average to determine tax expense and rate base deduction. The PUC explains its methods at pages 22A-28A and findings 3 and 5 (pp. 45A-46A at P.App. B.) The PUC clearly had the authority to make such an intrastate rate making adjustment. The Internal Revenue Code contains no restrictions on this method of intrastate rate making.

JDIC.

In regard to JDIC, General and Pacific have elected to use the ratable flowthrough method. The Code specifically provides only two circumstances under which eligibility can be lost. One is a 'cost of service reduction' in excess of ratable flowthrough. The second is a rate base reduction. (IRC Sec 46(f)(2), P.App. C, p 76A)

The Commission has set rates in strict conformity with these statutory requirements. A cost of service reduction is strictly based on ratable flowthrough and no rate base reduction occurs at any time. The method is fully described and approved by the California Supreme Court in *Los Angeles II.* (R.App. A, pp 33RA-46RA)

G. Conclusion—Tax Eligibility

The Court should not issue an advisory opinion on

the issue of eligibility. There is no present or even anticipated future tax controversy. Parties to any future controversy are not before this Court or in the proceedings below. The positions of litigants in this speculative future controversy are unknown. Eligibility will be retained under the clear language of the statutes. Pacific and General have only raised these issues as a regulatory tactic to gain excessive rates.

II. Limited Impact of Intrastate Rate Order.

In an attempt to gain certiorari, the telephone companies exaggerate the potential impact of the PUC decision. On pages 28 through 31, Pacific's petition paints a picture of gloom and doom if it is compelled to make refunds and rate reductions. These arguments are not new. In applying to the United States Supreme Court for a stay of the California Supreme Court's order in *Los Angeles I*, Pacific told this court, in No. A69, *Pacific Telephone* v. *City of Los Angeles*, "The amount involved is so large as to have a serious effect on the petitioner's financial condition and its ability to serve the public." (Page 19 fn. 27.) Pacific also argued to the PUC that if it ever adopted flowthrough the result would be "degradation of service and possible financial collapse" and that utilities would "go bankrupt." (*Los Angeles II* (R.App. A, p 26RA)

Justices White and Rehnquist denied Pacific's application for a stay of the California Supreme Court's order on July 28, 1972. The PUC then reset rates on the basis of flowthrough. As a result of these orders, Pacific refunded over $176,000,000 and reduced Pacific's rates by approximately $90,000,000 per year.

The PUC states in Decision 87838 that this refund and reduction resulted in no significant employee layoffs, no deterioration in service and no adverse effects on earnings. (P.App. B, p. 35A, 36A) Based on this

successful experience *Pacific* told the California Supreme Court that it was "financially capable of any . . . refunds" in the instant case. (Pacific Memo to California Supreme Court, August 16, 1974)

Now that refunds are at hand, Pacific takes the opposite tack and claims that such refunds and rate reductions "will have a destructive impact on Pacific's financial integrity." (Pac.Pet., p 28) Pacific's claim is baseless, disproven in the past, and is in contradiction of Pacific's claim to the California Supreme Court that it was financially capable of making any refunds.

Both Pacific and General argue that California's intrastate rate making treatment will have a significant national impact. At Pages 24 through 25 Pacific argues that "regulatory agencies throughout the country" may well take similar action. General argued, at page 19, "Regulators in other states must pay attention," and goes on to state that "every General telephone company and every telephone company in the Bell System is vulnerable." These arguments are without merit.

The PUC order is an *intrastate* rate decision based on specific findings of managerial imprudence. Neither the PUC nor the California Supreme Court can direct the policy of any other regulatory body. In the event any other jurisdiction attempted to adopt the California rate making methodology, AT&T and GT&E affiliates would strenuously argue against the applicability of the California method.

The California Supreme Court has made it clear that the methodology that was adopted by the PUC is not even binding on the PUC in future rate cases. (*Los Angeles II*, (R.App. A, fn. 42 pp 46RA, 47RA) We are left with a rate making method that has finally been approved by the California Supreme Court which is applicable to these companies at this point in time. The

case itself has taken a long time to resolve simply because the PUC, following Pacific's advice, refused to comply with the mandates of the California Supreme Court. An order has finally been issued by the PUC which complies with the California Supreme Court's mandate. The order has a minor transitory intrastate rate making impact. The issue is unworthy of Supreme Court review.

CONCLUSION

Petitioners have offered this Court no basis to grant their Petitions. The Petitions under consideration herein should be denied.

Respectfully submitted,

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